Farmshed Economics

The goal posts might shift, but it's still footy

March 2019

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In this edition of Farmshed Economics, we have added a *Special Topic* on the proposed capital gains tax, titled *The goal posts might shift, but it's still footy*. In it, we outline our thoughts on the Tax Working Group's proposal. Note though that we have kept our thoughts at a fairly high level as there's a good chance that the proposal gets watered down. And let's not forget, there's also a chance we don't see it all. That is, if the Government doesn't get re-elected in 2020, a National-led government is likely to unwind the changes.

Meanwhile, the 2018/19 dairy season is ending on a high – at least from a milk price point of view. So far this year, we have lifted our 2018/19 milk price forecast twice by a cumulative 60 cents to $6.60/kg.

The 2019/20 season is shaping up strong too. The global dairy market is tight as global supply is on the whole soft. At the same time, demand remains firm. On this basis, we see upside risk to our already-bullish 2019/20 milk price forecast of $7.00/kg.

Turning to the meat sector, lamb prices look like they have bottomed out at a healthy level. We expect spring prices to peak in the high $7.00/kg range, down from 2018, but still healthy. Meanwhile, beef prices are currently tracking at around their average level from the past 5 years. And we anticipate prices will stay near these levels over the remainder of the year.

The forestry sector has been on a record-breaking run, but we think log prices will run out of steam during the year. In particular, we don't think NZ will continue to grab market share off competitors like it has in recent years.

Looking at financial markets, benchmark interest rates have fallen to record lows. However, proposed changes to the amount of capital that banks are required to hold may mean that these lower rates don't flow through to farmers. Lastly, the NZD has largely traded sideways this year. Over the next six months, we expect the NZD to maintain this level or drift a fraction higher.

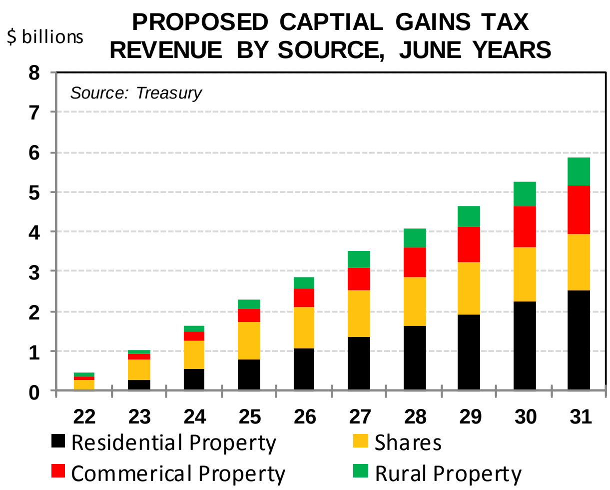
Note: In this edition, commodity price changes are relative to 3 months ago.

Key Rural Data:

As at 29 March 2019	Current	3 mths ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	104.5	86.0	99.3	↗
Lamb Price Index (NZD)	108.6	118.4	111.8	↗
Beef Price Index (NZD)	90.7	94.1	100.1	→
Forestry Price Index (USD)	104.5	101.2	106.9	↘
Interest Rates:				
90-day bank bills	1.85	1.99	1.96	↓
2-year swap	1.63	1.98	2.22	↘
5-year swap	1.77	2.23	2.62	↘
Exchange Rates:				
NZD/USD	0.6804	0.6715	0.7235	→
NZD/CNY	4.57	4.62	4.57	↗
NZD/GBP	0.5221	0.5284	0.5119	↗
Milk solids production (ytd % chg]**	4.9	4.9	1.8	↘
Fonterra Shareholders' Fund	4.25	4.64	5.91	→

*Direction of change over the next 6 months. **As at February 2019.

Chart of the Month:



? Rural Fact or Fiction?

Hemp is being grown at the site of the Chernobyl nuclear disaster to help cleanse the soil.

Answer on page 3

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Rural Commodities Outlook

Dairy – Ending on a high and a dry

Dairy Index (USD), 29 Mar:	104.5 ↑21.5 (qpc)

The 2018/19 season is ending on a high – at least from a milk price point of view. So far this year, we have lifted our 2018/19 milk price forecast twice by a cumulative 60 cents to $6.60/kg. For comparison that puts us at the top end of Fonterra's $6.30-$6.60/kg forecast range.

The forecast lifts follow eight successive auction price lifts. Indeed, whole milk prices have lifted around 25% so far over 2019. The price lift, however, is somewhat of a double-edged sword. At the same time we have progressively lifted our milk price forecast, we have also cut our 2018/19 production growth forecast to 3%, from 5% previously.

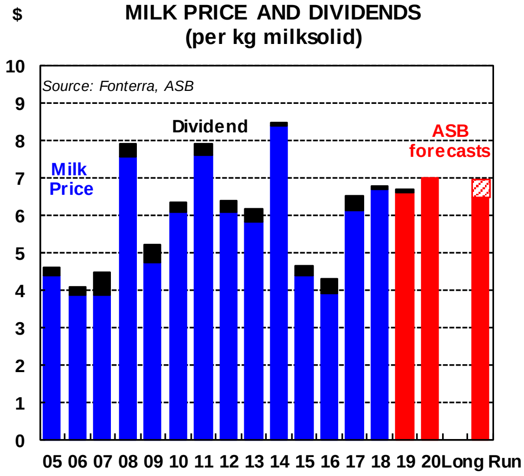
On a net income basis, the changes are positive for farmers. We estimate that the two changes add up to a circa $80,000 lift in forecast income for the average farmer for the season. Note, though, that there will be significant variation on a regional basis, based on the severity of the hot and dry weather in each region.

The 2019/20 season is shaping up strong too. The global dairy market is tight as global supply is on the whole soft. At the same time, demand particularly from Asia, including China, remains firm. On this basis, as well as the dry NZ conditions, we see upside risk to our already-bullish 2019/20 milk price forecast of $7.00/kg.

Season End Milk Price* Forecasts:

2018/19		2019/20	Long Run
Fonterra	ASB	ASB	ASB
$6.30-$6.60	$6.60	$7.00	$6.50-$7.00

* per kg of milk solids (excluding dividend)



Lamb – New season prices look set for silver medal

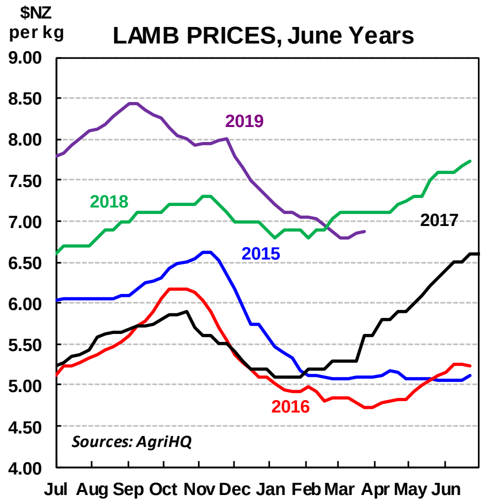
Lamb Index (NZD), 29 Mar:	108.6 ↓-8.3 (qpc)

Lamb prices (on a nationwide basis) look like they have bottomed out at around $6.80/kg. Prices did fall more than we expected over the beginning of 2019, but given the record highs reached in 2018, this is still a strong end to the summer.

We expect prices in the new season to peak in the high $7.00/kg range. In that sense, If last year's record breaking prices took out the gold medal, then the new season is more likely to take out silver.

Tight supply conditions that boosted last year's prices look set to continue. Meanwhile, demand remains strong in the US and firm in China, whereas traditional markets like the UK and EU continue to lose importance.

The main risk to this outlook is the performance of the Chinese economy. Beijing recently dropped its growth target to 30-year low. As a result, we will be keeping an eye on how Chinese demand holds up, but for now we retain our healthy outlook for lamb prices overall.



Beef – Middle of the road

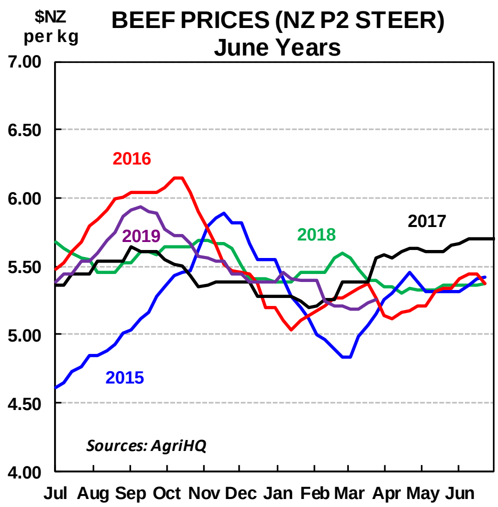
Beef Index (NZD), 29 Mar:	90.7 ↓-3.6 (qpc)

Beef prices are roughly middle of the road. Looking at P2 steer prices over the three months to date this year, prices are slightly below the levels posted in 2017 and 2018, but slightly above the levels posted in 2015 and 2016.

Over the remainder of the year, we expect prices to track this around middle ground. We come to this view as global supply and demand factors appear to be roughly in balance.

Global supply is growing, but at a moderate pace. US supply is growing as feed prices remain modest. In contrast, the Australian herd is shrinking following drought across the ditch.

Meanwhile, demand growth is modest, but nonetheless firm enough to match the pace of supply growth. In particular, Chinese beef demand continues to grow strongly. All up, these factors paint a picture of beef prices sitting around their 5-year average levels over the year.



Rural Commodities Outlook (continued)

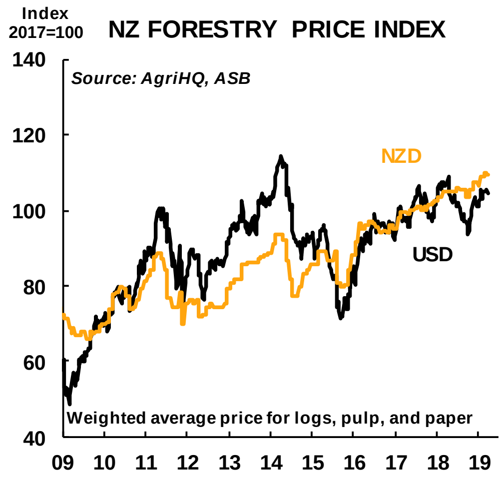
Forestry – Too good to be true

Log & Pulp Index (USD), 29 Mar:	104.5 ↑3.2 (mpc)

2018 was a fantastic year for forestry exports. Export receipts jumped $684 million from 2017. Moreover, forestry prices have started 2019 where they left off. Indeed, the Forestry Index has been at or just below record highs in NZD terms since mid-January.

However, we are doubtful that the record prices will last. Global demand for logs is flat, with log export volumes unchanged for the three months to December compared to the same three months a year ago. In fact, the main reason NZ prices are strong is that NZ log exporters have grabbed significant share off the other major log exporters. For example over the same period, NZ's market share increased 5 percentage points to 44%.

Looking ahead, we anticipate that global log demand will fall. World economic growth is slowing, particularly in China. Recall that China is NZ's largest log market by a long shot. In other words, unless NZ can continue to grab market share from other exporters, we are unlikely to be immune from flat demand for a second successive year.



Financial Markets Outlook

Interest Rates – Record lows, but…

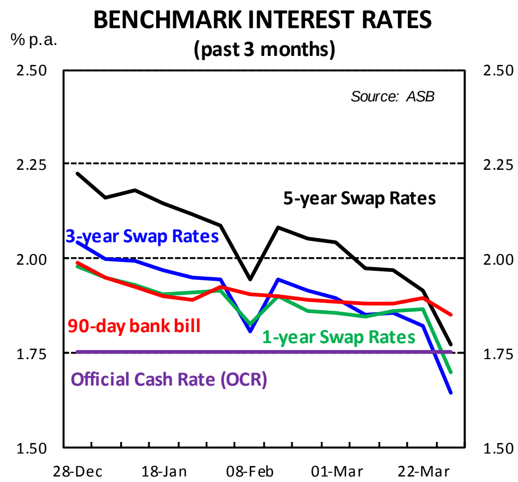
90-day bank bills, 29 Mar:	1.85% ↓-0.14 (qc)

All benchmark interest rates have fallen so far over 2019. In fact, other than short-term benchmark rates, all rates set record lows in either February or March of this year.

Over the next six months, we expect benchmark rates to head lower again. This view reflects our expectation that the Reserve Bank (RBNZ) will cut the Official Cash Rate (OCR) in May and August by a total of 50 basis points.

But farmers may not see the full benefits of these falls. The RBNZ is also proposing to increase banks' capital requirements. These requirements will increase bank funding costs, which may partly offset the impact of a lower OCR.

All up, interest rates for farmers are likely to remain low by historical standards. On balance, though, we judge that farmers' interest rates are likely to drift higher over the next few years.



NZ Dollar – Sideways with a hint of up

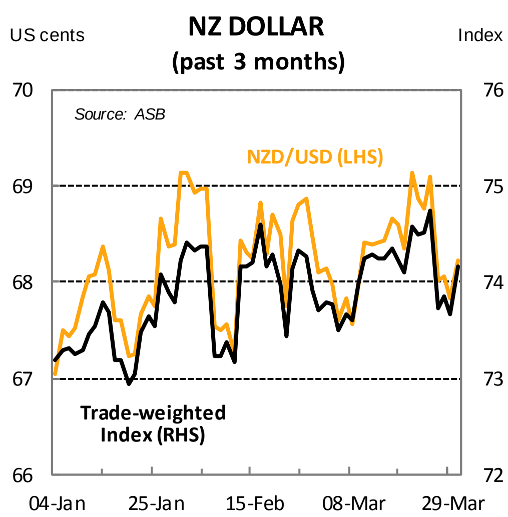
NZD/USD, 29 Mar:	0.6804 ↑ 0.0090 (qc)

The NZD has traded in a relatively tight range so far over 2019. With the exception of a very brief period at the start of the year, the NZD has tracked between US$0.67 and US$0.69. This trend has been despite NZ interest rates touching historical lows.

Rising dairy prices have helped support the NZD. As mentioned above, whole milk powder prices in USD terms have lifted around 25% over the first three months of the year. As stated above, we expect that strength to translate to a bullish milk price for the 19/20 season.

A more cautious tone from global central banks has supported the NZD. Indeed, the Federal Reserve now anticipates keeping its benchmark rate on hold this year, whereas late last year it anticipated further interest rate hikes.

Looking over the remainder of the year, we expect the NZD to average US$0.69, with the healthy dairy price outlook one key factor supporting the ongoing NZD firmness.



Rural Fact or Fiction?

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Answer: Fact! In a process called phytoremediation, hemp actually has the ability to remove toxins in the soil from places like Chernobyl.

Special Topic

Capital gains tax proposal – *The goal posts might shift, but it's still footy*

In this *Special Topic*, we outline our thoughts on the Tax Working Group's proposal. Note though that we have kept our thoughts at a fairly high level as there's a good chance that this proposal gets watered down. And let's not forget, there's also a chance we don't see it all. That is, if the Government doesn't get re-elected in 2020, a National-led government is likely to unwind any changes that are made.

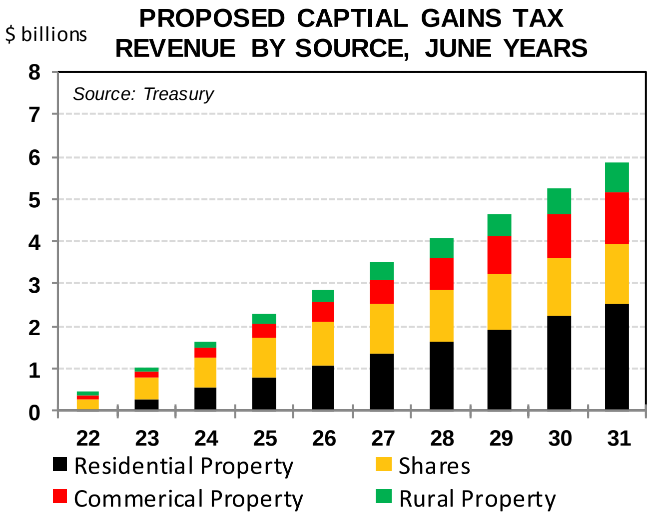
Tax Working Group

The highly anticipated final Tax Working Group (*the Group*) report was released on 21 February and by and large it contained what we expected it to i.e. it recommended a Capital Gains Tax (the focus of this article) on assets other than the family home amongst a variety of other proposals. By definition then, some farming assets could be captured by tax under *the Group's* proposals.

How much and when?

The tax would be paid at a farmer's marginal tax rate and would kick in from 1 April 2021. Gains on farming assets to date and through March 2021 would be off limits, but after that, they would be fair game. And assuming a farmer earns more than $70,000, then those gains would be taxed at 33% (or at the company rate if the farm is structured that way). Notably though, the gains would only be paid upon realisation i.e. at the time of the farm business sale.

The Group has estimated that around $8.3billion would be raised by the capital gains tax in its first five years. Around three-quarters of this amount would be paid on gains sourced from residential property and shares. Rural property would account for 10% of the revenue raised or around $860 million over the five years.



Who pays?

However, there are other important exemptions that would apply to the majority of farmers. For example, if a small or medium scale farmer sells his/her farm and then buys another similar, then the tax payment would be deferred in what's called rollover relief. To qualify for this relief, *the Group* suggests that annual turnover must be less than $5 million. Using dairy farms as an example, then farms with annual production of less than 750,000kg of milk solids[1] would qualify. Accordingly, this means the bulk of farmers will qualify for this relief. Also, like all tax payers the family home (even if on the farm) would also be exempt.

Next steps

It's important to note that *the Group's* proposals are just that. The Government now has the task of deciding what proposals to adopt as policy and what ones to not. It may also choose to water down some of *the Group's* proposals.

The Government also needs agreement from its coalition partners, notably NZ First. Previously, NZ First has been a vocal opponent of Capital Gains Tax. Accordingly, NZ First could play a moderating role and secure further exemptions or changes on top of the what is already included in *the Group's* proposal.

The final and arguably steepest hurdle for the Government is at the ballot box. Indeed, the 2020 election will be a stern test for the Government as it not only boils down to the merits of the capital gains tax policy itself, but also the Government's ability to sell it to voters, combined with its broader ability to win re-election.

[1] Assuming a total milk payout (farmgate milk price and dividend) of $6.65/kg and no other income.

What if a Capital Gains Tax does get through?

Bottom line, if the Capital Gains Tax is put through, farmers collectively will pay higher tax. But the question is – is a Capital Gains Tax the game charger for farming that some argue it is?

In the short term, we expect that land values are likely to adjust. Some farmers may choose to exit and take their earlier capital gains tax-free ahead of the April 2021 start date. If there is a large exit of farmers in a short period of time, then farm prices are likely to dip at that time.

But we note farm values have already been adjusting lower to be more in line with cash returns anyway. Indeed, farmers have already been factoring in higher costs of compliance and moving to lower levels of leverage amongst other things. Meanwhile, the Overseas Investment Office changes have taken most offshore buyers out of the market for the time being.

Moreover, rollover relief will apply to a large number of small and medium scale farmers. As such, larger corporate style farmers will pay a disproportionate amount of the tax raised. That said, we note that rollover relief will create an incentive to stay in the farming business longer than necessarily desirable (which the Tax Working Group describes as lock-in).

The goal posts might shift, but it's still footy

For our part, though, we think that farmers would adapt to this tax new environment as they have adapted to other changes in the past. And farming will continue to be about farmers' abilities to generate returns from the land. Long term, we are positive that will still be the case.

In other words, the goal posts might shift, but it's still footy.

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